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Activities of the Bureau of Alcohol, Tobacco
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Statement of
Paul L. Posner, Associate Director,
Tax Policy and Administration Issues

Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

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ACTIVITIES OF THE
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

SUMMARY OF STATEMENT
PAUL L. POSNER
ASSOCIATE DIRECTOR, TAX POLICY
AND ADMINISTRATION ISSUES

Faced with a relatively stable level of compliance staffing during a period of increasing responsibilities, the Bureau of Alcohol, Tobacco and Firearms (BATF) has had to make trade-offs in deciding how best to use its resources. For example, when BATF assumed responsibility from the Internal Revenue Service (IRS) in 1987 for collecting special occupational taxes, it decided to make a concerted effort to ensure that businesses were complying with those tax requirements. The increased staffing for that effort was accompanied by decreased staffing for alcohol tax compliance inspections which led to a 29 percent decrease in the number of those inspections between fiscal years 1988 and 1990.

The administration's fiscal year 1992 budget request would further diminish BATF's compliance presence. Although the request would increase BATF's authorized funding from \$306 million in fiscal year 1991 to \$317 million in 1992, that increase is primarily targeted for law enforcement. Funding for BATF's compliance function would be cut from \$85.2 million in 1991 to \$75.8 million and authorized staff years would be reduced from 1,417 to 1,152. According to BATF, the reductions proposed in the administration's fiscal year 1992 budget request would cause it to further reduce its presence in the alcohol industry by doing 2,000 (or 56 percent) fewer inspections directed at such things as screening applicants for business permits and testing products for contaminants. The proposed decrease comes at a time when BATF's compliance responsibilities continue to increase. Most recently, in January 1991, BATF assumed from IRS responsibility for collecting firearms and ammunition excise taxes.

GAO is concerned about the effect of BATF's reduced compliance presence. That concern is heightened by the fact that compliance inspections are done by inspectors who are not required to have any accounting expertise. BATF recognizes the need for such expertise and said it is considering requiring inspectors to have 6 credit hours of college-level accounting before they can be promoted to the journeyman level. Considering the nature of compliance inspections and the findings of other groups, like a BATF task force and consultant, who have commented on the issue, GAO believes that 12 hours may be more appropriate. GAO's testimony discusses other steps, like the use of standard inspection work plans, that it believes could be taken to improve BATF's efficiency. GAO is also issuing a report today which discusses these issues in more detail.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its hearings on the Bureau of Alcohol, Tobacco and Firearms (BATF). Our testimony today is based on the results of work we have been doing for the Subcommittee. Those results are more thoroughly documented in a report that we are issuing today.¹

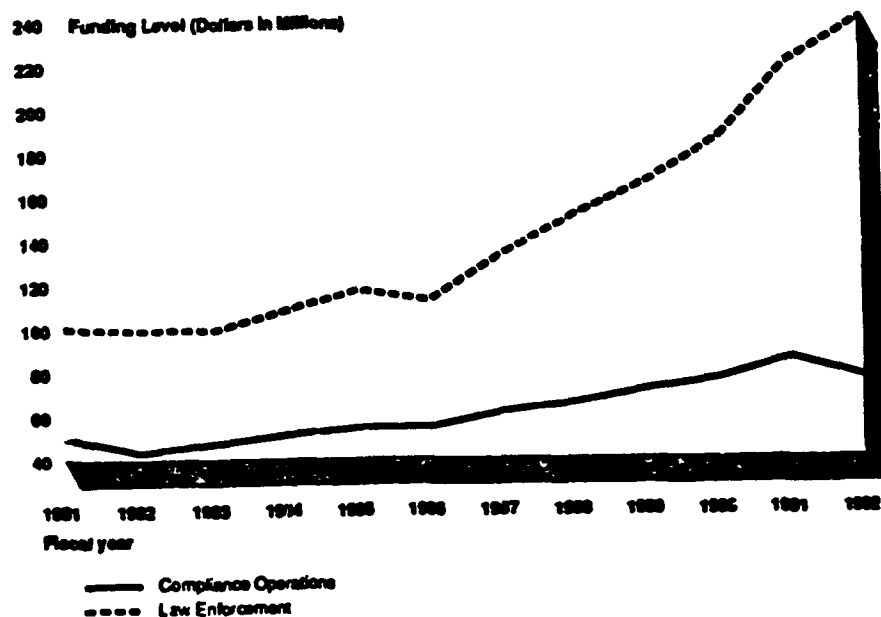
Over the past few years, BATF's law enforcement and compliance responsibilities have grown. At the same time, its staffing levels, especially in the compliance area, have remained relatively stable. Faced with that set of circumstances, BATF has had to make trade-offs as it decides how to best use its resources. One result of those trade-offs has been a reduction in BATF's presence in the alcohol industry--a reduction that concerns us because of its potential implications for tax compliance. Our testimony and report discuss various actions, such as increasing the accounting expertise of BATF's inspectors, that we think could be taken to improve BATF's efficiency and minimize the detrimental effects of trade-offs. Improved efficiency may be even more critical considering the reductions being proposed for BATF in the administration's fiscal year 1992 budget.

¹BATF: Management Improvements Needed to Handle Increasing Responsibilities (GAO/GGD-91-67, Mar. 20, 1991).

BATF'S BUDGET AND CURRENT RESPONSIBILITIES

BATF was authorized \$306 million and 4,066 staff years for fiscal year 1991. It is requesting \$317 million and 3,843 staff years for fiscal year 1992. Figure 1 shows how funding for BATF's two major organizational components--Compliance Operations and Law Enforcement--has changed from fiscal years 1981 through 1992, illustrating the growth of law enforcement relative to compliance.

Figure 1:
Funding for Compliance Operations
and Law Enforcement, Fiscal Years
1981 Through 1992



Fiscal year 1981 through 1990 data is actual, 1991 is authorized, and 1992 is requested.

Source: BATF data.

Compliance Operations

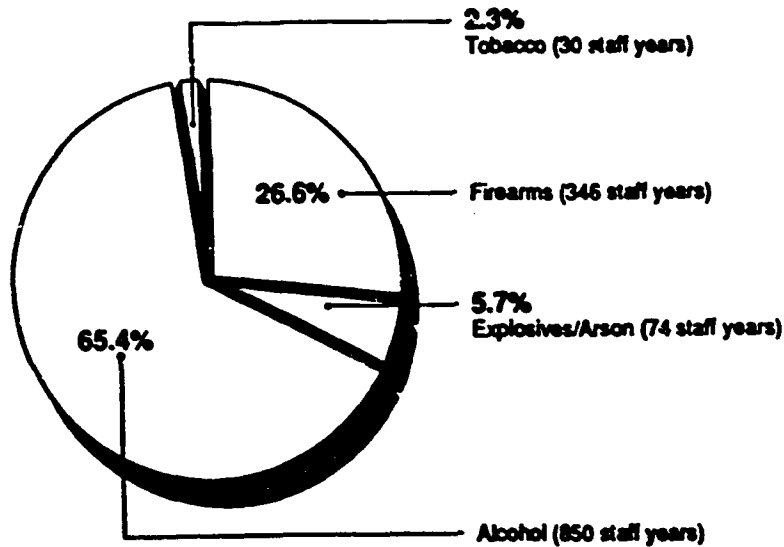
Compliance Operations regulates the alcohol, tobacco, firearms, and explosives industries and collects certain excise taxes. In fiscal year 1990, BATF collected \$5.8 billion in alcohol excise taxes; \$4.3 billion in tobacco excise taxes; \$1.3 million in firearms transfer taxes and making fees; and \$130 million in special occupational taxes imposed on businesses that sell alcohol, tobacco, and firearms. In fiscal year 1991, BATF assumed responsibility from the Internal Revenue Service (IRS) for collecting firearms and ammunition excise taxes. These taxes generated \$134 million in fiscal year 1989.

Compliance Operations also inspects alcohol and tobacco producers and wholesalers, tobacco export warehouses, firearms manufacturers and dealers, fireworks manufacturers, and explosives dealers and users. These inspections involve such tasks as investigating trade practices, checking that required records are accurately maintained, and verifying that the correct amount of tax has been paid. In addition, Compliance Operations (1) approves labels for alcoholic beverages; (2) helps protect the public by testing beverages for contaminants; and (3) screens applicants for permits and licenses to operate such businesses as distilleries, wineries, and breweries; to produce or export tobacco products; to import, manufacture, or sell firearms; and to manufacture, sell, or use explosives in interstate commerce.

BATF has assumed several compliance responsibilities in the past few years, including (1) the collection of special occupational taxes, which it assumed from IRS in July 1987; (2) the testing of alcoholic beverages in response to consumer complaints, which it assumed from the Food and Drug Administration in November 1987; (3) the taking of enforcement action (such as filing liens and seizing property) against delinquent alcohol and tobacco excise taxpayers, which it assumed from IRS in October 1990; and (4) the collection of firearms and ammunition excise taxes, which it assumed from IRS in January 1991. Despite those increased duties, the staffing levels proposed in the fiscal year 1992 budget would cut Compliance Operations staff years by 265 to a level of 1,152. This level is only 20 more staff years than it had in fiscal year 1987.

As shown in figure 2, the alcohol program accounted for about 65 percent of Compliance Operations' fiscal year 1990 direct staffing. The fiscal year 1992 budget request would cut that program by \$16 million and 258 staff years. Almost all of that decrease (\$15 million and 242 staff years) would come from doing 2,000 (or 56 percent) fewer inspections directed at such things as screening applicants for business permits and testing products. This reduction would contribute to BATF's declining presence in the alcohol industry, which we will be discussing in more detail later.

Figure 2:
Percentage of Staff Years Spent
on Compliance Operations' Four
Program Areas in Fiscal Year 1990



Compliance Operations had a total of 1,300 staff years in fiscal year 1990.

Source: BATF data.

Compliance Operations' second biggest program, in terms of staff years, is the firearms program. In fiscal year 1990, Compliance Operations did 11,977 firearms inspections--inspecting (at most) about 4 percent of the 269,079 firearms licensees. The fiscal year 1992 budget would reduce the firearms program by \$634,000 and 9 staff years, which, according to BATF, would result in about 600 fewer firearms inspections in 1992. That reduction will come at a time when BATF has assumed responsibility for collecting firearms and ammunition excise taxes and when the number of firearms licensees is expected to grow. BATF expects

the number of licensees to increase about 2 percent in 1992 to 275,000.

BATF's other two programs, tobacco and explosives, are budgeted to receive an additional \$124,000 and \$300,000, respectively. The budget request calls for no change in the authorized staff years for either of those programs.

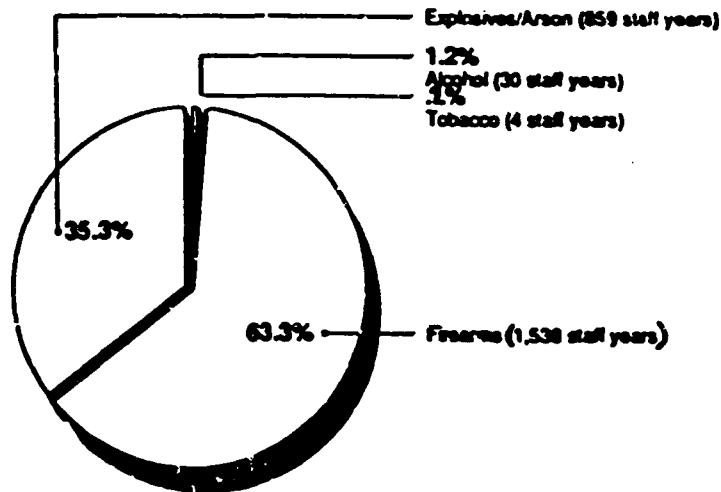
Law Enforcement

BATF's Office of Law Enforcement is primarily responsible for enforcing federal firearms and explosives laws and investigating criminal violations. Law Enforcement agents investigate such things as firearms and narcotics trafficking, large scale thefts of firearms, and domestic and international terrorism; and they help local law enforcement agencies investigate arsons involving interstate commerce. BATF's role in the war on drugs was made more important by the mandatory sentencing provisions contained in the Comprehensive Crime Control Act of 1984, as amended in 1988. Those provisions stipulate minimum sentences of 5 years to life for criminals convicted of possessing a firearm while committing violent or drug-related crimes, making BATF's firearms expertise crucial in developing cases involving these provisions.

From fiscal year 1987 through 1990, the number of Law Enforcement staff years increased 36 percent (from 1,793 to 2,431) and the total number of cases referred for prosecution increased 53 percent. Of the 1,774 special agents on board as of July 1, 1990, about 36 percent had been hired since fiscal year 1987. Law Enforcement was authorized 2,649 staff years and \$220.5 million in fiscal year 1991; those numbers would increase to 2,691 staff years and \$241 million under the fiscal year 1992 budget request.

Law Enforcement's top priorities are narcotics and violent crimes. Consistent with these priorities, as shown in figure 3, Law Enforcement concentrates on firearms and explosives cases while doing little work relating to alcohol and tobacco.

Figure 3:
Percentage of Staff Years Spent
on Law Enforcement's Four Program
Areas in Fiscal Year 1990



Law Enforcement had a total of 2,431 staff years in fiscal 1990.

Source: BATF data.

As part of the firearms program, Law Enforcement agents investigate such things as firearms theft, firearms and narcotics trafficking, violent crime, street gangs, and organized crime. That program has grown as BATF's firearms expertise has become critical to the government's anti-drug effort. As evidence of this growth, the number of Law Enforcement staff years devoted directly to the firearms program has increased from 750 in fiscal year 1986 to 1,334 in fiscal year 1990. The fiscal year 1992 budget request calls for further increasing firearms staffing by 120 staff years, or 7 percent, including a reprogramming of 58

positions from the explosives program and 20 positions from the alcohol program. As described in the budget, this shifting of resources is necessary to ensure the most effective use of BATF's limited resources in combatting violent crime. At the same time, the movement of 20 staff years from Law Enforcement's alcohol program would leave only 10 staff years allocated to the program to investigate alcohol tax fraud.

COMPLIANCE OPERATIONS' INCREASING WORKLOAD COULD
INCREASE THE RISK OF NONCOMPLIANCE WITH EXCISE TAX LAWS

With increasing compliance responsibilities and relatively stable compliance staffing, BATF has had to make trade-offs as it decides how best to use its resources. When BATF assumed responsibility for special occupational taxes, for example, it decided to undertake a concerted effort to ensure that businesses were complying with those tax requirements. As a result, the number of special occupational tax inspections increased over 400 percent from fiscal year 1988 to 1989. The increased staffing needed for that undertaking was accompanied by a reduction in the number of tax compliance inspections of alcohol producers. BATF reduced the number of staff hours spent on tax compliance inspections from about 94,000 in fiscal year 1988 to about 67,000 in fiscal year 1990, which led to a 29 percent decrease in the number of those inspections.

We understand the need to make trade-offs and appreciate the difficult choices BATF faces in allocating its resources. At the same time, however, we are concerned that reductions in BATF's presence in the alcohol industry could put alcohol excise tax revenues at risk. That risk could be exacerbated by (1) additional trade-offs that may be necessitated now that BATF has assumed responsibility for firearms and ammunition excise taxes; (2) the increased alcohol excise tax rates enacted in 1990 that could prompt greater noncompliance; (3) the alcohol program reductions in the fiscal year 1992 budget request that we discussed earlier; and (4) Law Enforcement's reduced presence in investigating alcohol and tobacco tax fraud schemes.

An additional factor that adds to our discomfort about BATF's declining number of tax compliance inspections is that they are done by inspectors who are not required to have a background in accounting. As of March 1991, BATF had about 420 field inspectors and only 42 auditors. The auditors spend most of their time on arson-for-profit investigations, not on tax compliance.

According to information we obtained from studies done at BATF by an internal task force, an outside consultant, and others, and from the Chief of BATF's Audit Branch, at least some accounting should be required of anyone doing tax compliance work. Although inspectors are not required to have a background in

accounting or auditing to be hired, BATF officials said that they strongly encourage and will pay for inspectors to take accounting classes. BATF's data shows, however, that only 29 percent of their field inspectors had achieved 12 or more hours of accounting credits.

We believe that bringing more accounting expertise to bear, at least on the more complex tax compliance inspections, would help alleviate the risk of noncompliance. Such expertise would be very useful in tying the excise taxes paid to the corporate books of account, verifying production records, and checking internal controls. Officials from one brewery told us that auditors generally do a more competent job and that inspectors do not understand accounting terms such as cost figures, finished goods, and inventory systems.

Firearms and ammunition excise tax inspections, for which BATF recently became responsible, would seem to require even more accounting expertise than alcohol inspections because those taxes are based on a percentage of the initial sales price, rather than on a unit amount as is the case with alcohol and tobacco taxes. Because the amount of firearms excise tax due is dependent on the price of the weapon, BATF, in determining the correct amount of tax, must ensure that the sales price reflects the true value of the goods and must be alert to schemes that are intended to defraud the government of tax revenues.

We understand the need for BATF to use its auditors on complex arson-for-profit cases. We are recommending in our report that if that workload continues at a pace that does not permit focusing more of the existing auditors' time on tax compliance inspections, BATF consider other steps it can take to better ensure that accounting expertise is available when needed. BATF might, for example, change its mix of inspectors and auditors by hiring auditors to fill vacated inspector positions. Although inspectors could still be responsible for doing most of the inspections, a group of auditors devoted to the compliance function could help by providing guidance, training, quality review, and troubleshooting for compliance inspections. Another possible step that BATF officials said they were already considering would be to require that an inspector successfully complete some credit hours of accounting before being eligible for promotion to the journeyman level. BATF officials said they were thinking of setting the requirement at 6 hours; we think 12 hours might be more appropriate.

One could validly ask whether the issues we have just discussed have had any adverse effect on compliance or revenues. The answer, unfortunately, is that neither we nor BATF know.

In fiscal year 1990, BATF inspectors examined alcohol excise tax returns involving reported tax liabilities of \$841 million and

identified about \$1.8 million in additional taxes due--a yield of 0.2 percent of the excise taxes examined. Neither we nor BATF can tell whether those results are indicative of the level of compliance or whether the results might be enhanced by using auditors on some of the inspections. These results also do not reflect the deterrent value of BATF's presence in preventing additional noncompliance. BATF does not have the kind of data needed to make those kinds of determinations. More specifically, it does not periodically assess the extent of compliance among businesses subject to the excise taxes it collects. BATF officials believe there is about a 99-percent level of compliance with alcohol and tobacco excise taxes, and they base that belief, in large part, on the fact that inspectors do not find much in the way of additional tax due as a result of their inspections. The question is: are inspectors not finding anything because compliance is high or are they missing things because of inadequate accounting expertise?

OTHER STEPS COULD BE TAKEN TO IMPROVE

THE EFFICIENCY OF BATF'S COMPLIANCE PROGRAMS

Besides bringing more auditing expertise to bear on BATF's tax compliance inspections, other steps could be taken to enhance BATF's operational efficiency. Those steps involve (1) BATF developing standard work plans for its inspections, (2) legislation to change the incidence of the special occupational

tax from the retail level to the producer and importer level, and
(3) BATF analyzing data from several years' tests of alcoholic
beverages to better target future tests.

Work plans are required for each compliance inspection (23,596 in
fiscal year 1990). These plans can vary considerably in depth of
coverage. For example, we compared work plans for two winery tax
compliance inspections. Both plans called for verifying that the
correct tax was paid for wine leaving a winery. One plan simply
said to verify taxable removals and use statistical sampling if
practical. The other plan listed seven audit steps to address
the same issue, such as evaluating internal controls and testing
the accuracy of removal records, including cross checking
several different records to assure consistency and completeness.
The second plan more clearly and thoroughly defined what should
be done in the inspection.

Standard work plans would provide for a more efficient use of
resources and would help ensure that a minimum amount of work is
done at each inspection, thereby promoting greater uniformity in
coverage. Standard plans would also help inspectors with little
accounting expertise do tax compliance inspections by setting
forth steps to follow in doing the work. BATF officials said
that a draft work plan for use in inspecting breweries would be
available later this month.

The special occupational taxes are cumbersome and costly for BATF to administer because they require collecting relatively small amounts (\$250 annually for alcohol retailers) from an estimated 550,000 retailers, ranging from high volume liquor stores to small "mom and pop" grocery stores. Since assuming responsibility for these taxes in 1987, BATF has had difficulty identifying the alcohol retailers subject to the tax. In a September 1990 report², we analyzed alternatives to reduce BATF's administrative costs and the compliance burdens for thousands of retailers. We suggested that Congress consider either eliminating the tax with a corresponding increase in the excise tax rates or collecting the tax at the producer and importer level only and varying the tax on the basis of the size of the facility.

In the fiscal year 1992 budget, the administration proposes to reduce BATF's costs by requiring wholesalers to verify payment of the tax by their retailers before selling their products. Although this approach may promote increased compliance with reduced federal costs, we still believe that changing the incidence of the tax as we suggested in our previous report would be a more efficient solution because it would significantly reduce the number of taxpayers.

²Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency, (GAO/GGD-90-123, September 27, 1990)

BATF could also better target its tests of alcoholic beverages. In fiscal year 1990, BATF tested 387 products from 6 cities under its market basket sampling program. It tests those products to determine if they comply with formulas or if they are contaminated. In deciding which products to sample, BATF gets input from knowledgeable persons, including chemists in the BATF labs where the products are tested, and analyzes recent laboratory test results. We are recommending a more systematic approach--one that would involve establishing a management information system and analyzing results from tests done over a period of several years. Such information is available on an existing BATF database. By analyzing patterns in the results of previous tests and other characteristics from the sample (such as the manufacturer, the type of retail business where a problem was identified, and the type of product), BATF would be better able, in our opinion, to target its sampling efforts.

The alcohol program reduction provided for in the fiscal year 1992 budget request and discussed earlier in our testimony may make the above discussion moot. According to BATF, that reduction would result in no inspectors being available to do market basket sampling.

GROWTH IN LAW ENFORCEMENT HAS INCREASED

DEMANDS ON SUPPORT FUNCTIONS

As discussed in our report, the growth in Law Enforcement's firearms program has generated some backlogs that can affect BATF's timeliness and/or effectiveness. This growth is likely to continue, considering the 7 percent increase in staffing being requested for fiscal year 1992 in Law Enforcement's firearms program. BATF's plans to deal with one of those backlogs, which involves the microfilming of records used to trace the ownership of firearms, would be affected by the proposed budget.

BATF traces the ownership of firearms to help law enforcement agencies identify criminals and for use in the preparation of indictments. As such, it is important that they be done in a timely manner. The number of traces increased from 27,050 in fiscal year 1987 to 44,272 in fiscal year 1990—a jump of 63 percent. To trace ownership of a firearm, BATF contacts manufacturers, wholesalers, and dealers who are required to keep certain records on their transactions. A company going out of business is required to send its records to BATF's Out-of-Business Records Section, so that they are available for research as part of the trace. According to BATF, records in the Out-of-Business Records Section are used in about 25 percent of the traces. BATF is trying to microfilm those records because use of

microfilmed records is quicker and microfilming protects against deterioration. As of June 1990 BATF had 28 million documents that had to be microfilmed. This backlog could worsen if economic conditions cause the number of businesses ceasing operations to increase.

In fiscal year 1991, BATF hired a contractor to begin reducing this backlog. BATF's request for \$1 million for microfilming in fiscal year 1992 was denied by the Office of Management and Budget during the budget formulation process. We believe that microfilming these records is a more cost effective approach than allowing the backlog to continue to grow and incurring the additional costs associated with storing and researching the paper documents.

BETTER MANAGEMENT INFORMATION

COULD HELP BATF MANAGE

ITS WORKLOAD

BATF would be better able to handle its growing workload and make necessary trade-offs, in our opinion, if it had better data with which to assess how well it is doing and to provide a basis for determining future directions. Compliance information, such as the number of facilities inspected and the size of any tax gap, are examples of data that could be useful. Also helpful would be data on the quality and timeliness of BATF's law enforcement

efforts, in addition to monitoring the number of cases and suspects referred for prosecution as BATF does now.

CONCLUSION

In the current budget climate, BATF, like other federal agencies, is faced with the challenge of doing more with scarce resources. BATF's compliance resources have been stretched to cover new duties. We are/ concerned that one result of that stretching, a declining presence in the alcohol industry, could lead to increased noncompliance in the long run. The lack of accounting expertise on tax inspections and the absence of any tax gap data serve to heighten our concern. The steps we have outlined today could help alleviate that concern by enabling BATF to use its resources more efficiently and effectively.

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That concludes my prepared statement. We will be happy to respond to any questions.

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